

Department of Water Resources Electric Power Fund Financial Statements

For the years ended June 30, 2003 and 2002



Department of Water Resources Electric Power Fund

Index

	Page
Report of Independent Auditors.....	1
Management’s Discussion and Analysis.....	2
Statements of Net Assets	10
Statements of Activities	11
Statements of Cash Flows.....	12
Notes to Financial Statements.....	13

Report of Independent Auditors

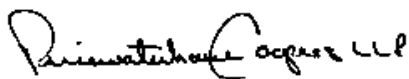
The Director of the State of California
Department of Water Resources

In our opinion, the accompanying statements of net assets and the related statements of activities and cash flows present fairly, in all material respects, the financial position of the Department of Water Resources Electric Power Fund (Fund), a component unit of the State of California, as of June 30, 2003 and 2002, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Fund's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As explained in Note 1 to the financial statements, the Fund is involved in certain lawsuits and regulatory proceedings that could impact power costs and the related revenue requirements, and the terms and conditions of the power purchase contracts. Because of the early stage of the legal and regulatory proceedings, the ultimate outcome of these matters cannot be presently determined.

The Management's Discussion and Analysis is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurements and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated October 14, 2003, on our consideration of the Fund's internal control over financial reporting and on our tests of its compliance with laws and regulations, contracts and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.



October 14, 2003

Department of Water Resources Electric Power Fund Management's Discussion and Analysis

USING THIS REPORT

This discussion and analysis is designed to assist the reader in focusing on significant financial issues and activities and to identify any significant changes in financial position of the Department of Water Resources Electric Power Fund (Fund), which is administered by the California Department of Water Resources (DWR). Readers are encouraged to consider the information presented in conjunction with the financial statements as a whole, which follows *Management's Discussion and Analysis*.

The basic financial statements include three required statements, which provide different views of the Fund. They are: the statement of net assets, the statement of activities and the statement of cash flows. These statements provide current and long-term information about the Fund and its activities. These financial statements report information using accounting methods similar (although not identical) to those used by private sector companies. The statement of net assets includes all assets and liabilities as of the year-end date. The statement of activities presents all of the current year's revenues and expenses. The final required statement is the statement of cash flows. This statement reports cash receipts, disbursements and the net change in cash resulting from three principal types of activities; operating activities, financing activities and investing activities. In order for the basic financial statements to be complete, they must be accompanied by a complete set of footnotes. The notes to the financial statements provide disclosures which are required to conform with generally accepted accounting principles. The Fund has adopted accounting standards promulgated by the Governmental Accounting Standards Board.

HISTORY AND INITIAL FINANCING

The Fund was established in January 2001, in connection with the Governor of California's emergency proclamation and subsequent legislation to assist in mitigating the effects of a statewide energy supply emergency. The enabling legislation included the following powers and requirements:

- Authorization to secure and requirement to retain title to power for resale to end use customers of the State's investor owned utilities (IOUs).
- Authorization to enter into servicing arrangements with the IOUs for transmission, distribution, billing and collection services.
- Entitlement to recover revenue requirements for authorized activities, including but not limited to debt service, the costs of power purchases, administrative costs and reserves.
- Authorization to enter into agreements with the California Public Utility Commission (CPUC) to ensure collection of DWR's revenue requirements.
- Restriction from entering into new power supply contracts after December 31, 2002.
- Authorization to administer existing power supply contracts after December 31, 2002.
- Authorization to issue revenue bonds not to exceed \$13.4 billion.

Additional background is provided in Note 1 to the financial statements.

Through June 26, 2001, advances from the State's General Fund were used to make payments for purchased power, as permitted by the enabling legislation. All of the advances, totaling \$6.2 billion, were repaid with the proceeds from the October and November 2002, bond issues. On June 26, 2001, additional funding for power purchases was provided from the net proceeds of a \$4.3 billion term loan from a financial consortium led by JPMorgan Chase Bank, the outstanding balance of which was also repaid from the proceeds of the October 2002, bond issue.

Department of Water Resources Electric Power Fund Management's Discussion and Analysis

SALE OF REVENUE BONDS

In November 2002, DWR completed the issuance of \$11.3 billion in revenue bonds. All bonds, except for Series E, are tax-exempt.

A table summarizing the bond issues by series follows:

Series	Rates	Fiscal Year of Final Maturity	Par Value (in millions)
A	3.0-6.0%	2022	\$ 6,314
B	Variable	2020	1,000
C	Variable	2022	2,750
D	Variable	2022	500
E	3.6-4.3%	2006	700
			<hr/>
			\$ 11,264

Effective February 2003, DWR entered into \$1.4 billion notional amount of forward interest rate swaps, reducing its un-hedged variable rate exposure to approximately 25% of the initial par value of the bonds issued.

The proceeds of the bond issues, along with \$2.1 billion of cash and investments in the Fund, were used to repay the term loan, repay advances from the State's General Fund, and establish separate accounts in the Fund as required by the Bond Indenture. The bonds are payable from Bond Charges and, if necessary, other revenues, collected over a 20 year period. The primary cash and investment accounts established by the Bond Indenture, their purpose and their source of revenue are identified below:

Bond Charge Accounts:

- **Bond Charge Collection Account:** Bond Charges are specific charges to IOU customers and certain customers of "direct access" Electric Service Providers (ESPs) based on all power (including DWR, IOU and ESP power) delivered to such customers and are used for debt service and other debt related costs. Bond Charges are deposited into the Bond Charge Collection Account. Monthly, funds needed for debt service payments are transferred to the Bond Charge Payment Account.
- **Bond Charge Payment Account:** Monies in the Bond Charge Payment Account are used to pay debt service, swap payments and related fees for the revenue bonds. After receipt of the monthly transfer from the Bond Charge Collection Account, the balance in the Bond Charge Payment Account must at least equal the debt service, swap payments and fees estimated to accrue or be payable for the next succeeding three months.
- **Debt Service Reserve Account:** The Debt Service Reserve account must maintain a balance equal to the amount of maximum aggregate annual debt service on all outstanding debt, including net scheduled swap payments.

Department of Water Resources Electric Power Fund

Management's Discussion and Analysis

Power Charge Accounts:

- Operating Account: Power Charges are charges to IOU and ESP customers for all DWR power purchased by the Fund for the benefit of the IOU customers. Power Charges and miscellaneous revenue are deposited into the Operating Account. Monthly, funds are transferred to the Priority Contract Account as needed to make payments on Priority Contracts. Remaining monies are available for payment of costs other than Priority Contracts, debt service and debt related costs.
- Priority Contract Account: Priority Contracts are those long-term power purchase contracts that require monthly payment prior to any debt service payments. Monies in the Priority Contract Account are used to make scheduled payments on Priority Contracts. After the monthly transfer from the Operating Account on the fifth of the month, the Priority Contract Account is projected to have monies sufficient to make scheduled payments on Priority Contracts through the fifth of the following month.
- Operating Reserve Account: The Operating Reserve account must maintain an amount equal to the greater of (i) seven months of projected negative operating cash flows under a stress scenario, as defined or (ii) a specified percentage of projected annual operating expenses of the Fund, as defined.

STATEMENT OF NET ASSETS

The Fund's assets and liabilities as of June 30, are summarized as follows (in millions):

	2003	2002
Cash and investments, including restricted cash	\$ 1,683	\$ 2,129
Recoverable costs, current portion	1,129	1,318
Other current assets	36	33
Long-term restricted cash and investments	1,704	-
Recoverable costs, net of current portion	7,568	7,263
Total assets	<u>\$ 12,120</u>	<u>\$ 10,743</u>
Long-term debt, including current portion	\$ 11,636	\$ 10,345
Other current liabilities	484	398
Total capital and liabilities	<u>\$ 12,120</u>	<u>\$ 10,743</u>

Restricted Cash and Investments

Prior to the issuance of the revenue bonds in November 2002, all cash and investments were maintained in one account, which was classified as a current asset. As required by the Bond Indenture, six separate restricted cash and investments accounts were established. Four of the accounts are classified as current assets, while the Operating Reserve Account and Debt Service Reserve Account are classified as long-term assets. Restricted cash and investments total \$3.3 billion at June 30, 2003. From the dates of issuance of the initial revenue bonds through June 30, 2003, the balances in each of the restricted cash and investments accounts met or exceeded balances required by the Bond Indenture.

Department of Water Resources Electric Power Fund Management's Discussion and Analysis

Projected cash balances of the Operating Account and Operating Reserve Account for periods subsequent to June 30, 2003, resulting from DWR's development of the 2003 Supplemental Revenue Requirement filed with the CPUC on July 1, 2003, are discussed in the Management's Discussion and Analysis section entitled *Transition of Responsibilities, Decrease in Required Account Balances, and Implementation of 2003 Supplemental Revenue Requirement*.

Other Investments

DWR purchases natural gas as fuel for the production of power under the terms of certain long-term power purchase contracts. DWR maintains a brokerage account with a national brokerage firm in order to hedge natural gas fuel costs. This account is classified as other investments on the Statements of Net Assets. At June 30, 2002, the account consisted of money market obligations and government bonds valued at \$9 million and financial futures and options valued at \$1 million. During fiscal 2003, \$40 million was transferred from the Operating Account to the brokerage account. At June 30, 2003, the account consisted of money market obligations and government bonds valued at \$21 million and financial futures and options valued at \$16 million. During the year ended June 30, 2003, net losses on settlement of options and futures contracts amounted to \$6 million. At June 30, 2003, DWR has open positions with an unrealized marked-to-market value decrease of \$7 million.

Recoverable Costs

The current portion of recoverable costs reflects billings to IOU customers that have not yet been collected. The current portion of recoverable costs decreased \$189 million from June 30, 2002 to June 30, 2003, primarily due to the IOUs payment on past due amounts related to imbalance energy supplied through the California Independent System Operator (ISO) market.

Long-term recoverable costs consist of costs that are recoverable through future billings. The majority of the \$305 million increase is associated with costs related to the issuance of the revenue bonds.

Discussion of changes subsequent to June 30, 2003, in both current and long-term recoverable costs from DWR's development of the 2003 Supplemental Revenue Requirement filed with the CPUC on July 1, 2003, may be found in the Management's Discussion and Analysis section entitled *Transition of Responsibilities, Decrease in Required Account Balances, and Implementation of 2003 Supplemental Revenue Requirement*.

Revenue Bonds

The amount of revenue bonds outstanding at June 30, 2003, reflects the par value of the bonds issued plus unamortized premium of \$372 million. The first principal payment (\$180 million) for the revenue bonds is scheduled for May 2004. The proceeds of the revenue bonds, plus \$2.1 billion of cash and investments in the Fund, were used to 1) repay all amounts, including interest, owed to the State General Fund, 2) repay the term loan, both of which had balances outstanding at June 30, 2002, and 3) fund restricted cash and investment accounts established by the issuance of the revenue bonds.

Accounts Payable

Accounts payable at June 30, 2003 and June 30, 2002, are comparable and reflect one month's accrual for priority contract power purchases, as payments are normally made on the 20th of the month following purchase.

Department of Water Resources Electric Power Fund Management's Discussion and Analysis

Accrued Interest Payable

Accrued interest payable of \$69 million at June 30, 2003, represents accrued interest due on the revenue bonds and accrued net scheduled payments on the related swaps. The fixed rate bonds provide for semi-annual payments on May 1st and November 1st, while the variable rate bonds provide for more frequent payments. Accrued interest payable at June 30, 2002, reflects two days of accrued interest expense for the term loan. Accrued interest due to the General Fund at June 30, 2002, is included in the Advances from the State General Fund.

STATEMENT OF ACTIVITIES

The Fund's activities for the years ended June 30, are summarized as follows (in millions):

	2003	2002
Power charges and other	\$ 4,985	\$ 4,241
Expenses:		
Power purchases	4,517	4,742
Interest expense	444	562
Other	328	73
Deferral of recoverable costs	(304)	(1,136)
Total expenses	4,985	4,241
Net income	-	-
Net assets, beginning of year	-	-
Net assets, end of year	\$ -	\$ -

Power Charges

The cost of providing energy is recoverable primarily through Power Charges to IOU and certain ESP customers. These charges are collected by the IOUs as agent for DWR and forwarded to DWR daily. Charges are determined by applying a CPUC adopted rate for each IOU to the megawatt hours of power delivered by DWR to each IOU's customers. Power Charges increased by \$378 million in 2003 as compared to 2002, a 9% increase. This increase is primarily attributable to an 8% increase in power delivered during fiscal year 2003, and increased rates effective January 2003.

Bond Charges

The Bond Charge was established in November 2002, to pay for debt service on the revenue bonds. Bond Charges are determined by applying a CPUC adopted rate to the total megawatt hours of power delivered to customers in each IOU's service area and certain ESP customers. Bond Charges earned through June 30, 2003, were \$407 million and are comparable to those forecast in the cash flow analyses utilized in developing the revenue bond structure.

Department of Water Resources Electric Power Fund Management's Discussion and Analysis

Interest Income

The \$41 million decrease in interest income between the years ended June 30, 2003 and 2002, as well as the decrease in accrued interest receivable at June 30, 2003, is directly related to the differences in rates available for short-term investments between the two years.

EXPENDITURES

Power

DWR power costs were \$225 million less in the year ended June 30, 2003, than in the year ended June 30, 2002, even though DWR purchased eight percent more power in 2003. The average cost per MWh for both long-term contract power and short-term power was approximately \$10 per MWh less in fiscal 2003 than in fiscal 2002.

The increase in power delivered is due to a 50% increase in volume in 2003 from long-term contracts as new plants financed by the long-term contracts began production. This increase was partially offset by the successful transition of short-term power purchasing to the IOUs in January 2003.

Costs Incurred for Issuance of Revenue Bonds

The costs incurred for issuance of revenue bonds for the year ended June 30, 2003 and 2002, were \$257 million and \$26 million, respectively. The expense for the year ended June 30, 2003, includes payments in October and November 2002, totaling \$236 million from bond proceeds for credit enhancement fees, including bond insurance premiums, and underwriters' fees.

Interest Expense

Interest expense incurred during the year ended June 30, 2003, is \$118 million less than that incurred during the year ended June 30, 2002. While total borrowings increased during the year ended June 30, 2003, the overall interest rate for the revenue bonds issued in November 2002, is 4.8% and is less than the interest rates for both the General Fund advances and the term loan, which were 5.3% and 5.7%, respectively.

Administrative Expenses

Administrative expenses were \$24 million higher in the year ended June 30, 2003, than in the prior year because of increased expenditures for the renegotiation of long-term contracts, litigation, and one time costs incurred in the transition of certain power procurement responsibilities to the IOUs.

TRANSITION OF RESPONSIBILITIES, DECREASE IN REQUIRED ACCOUNT BALANCES, AND IMPLEMENTATION OF 2003 SUPPLEMENTAL REVENUE REQUIREMENT

Effective January 1, 2003, DWR transitioned certain power procurement responsibilities to the IOUs. DWR no longer purchases power, except power provided under the terms of its existing contracts. DWR also transferred the scheduling, dispatch, and certain other administrative functions for the existing contracts to the IOUs. However, DWR retains the legal and financial responsibility for the existing contracts until such time as there is complete assignment of the contracts and release of DWR.

Department of Water Resources Electric Power Fund Management's Discussion and Analysis

While DWR was responsible for procurement of the "residual net short" (as defined in the Bond Indenture), DWR was required under the terms of the Bond Indenture to maintain a minimum Operating Account balance of \$1 billion. Under the terms of the Bond Indenture, with the end of that responsibility DWR can now reduce the minimum Operating Account balance to the maximum amount projected by DWR by which operating expenditures may exceed Power Charges during any one calendar month, taking into account a range of possible future outcomes that DWR deems to be appropriate.

Also, because of the end of that responsibility, DWR can reduce its Operating Reserve Account balance to the greater of (i) seven months of projected negative operating cash flows, taking into account a range of possible future outcomes that DWR deems to be appropriate, or (ii) 12% of projected annual operating expenses of the Fund. Before the end of that responsibility, the second test was 18% of projected annual operating expenses of the Fund.

In the first half of calendar year 2003, DWR conducted an internal review of its 2003 Revenue Requirement, which was originally determined in August 2002. Upon completion of internal analyses, which included analyzing actual results through March 31, 2003, the 2003 Supplemental Revenue Requirement was developed and submitted to the CPUC for implementation on July 1, 2003. Based on 1) the ability to reduce reserves, 2) the expected receipt of cash for past due amounts being held in trust by PG&E, and 3) increases in actual and forecasted costs, the 2003 Supplement Revenue Requirement reduced DWR's 2003 revenue requirement needs by \$1.002 billion.

A summary of the principal changes between the 2003 Supplemental Revenue Requirement and the original 2003 Revenue Requirement follows (in millions):

Description

January 1, 2003 Operating Account balance higher than originally forecasted	\$ 44
Reduction in required balance for Operating Account	652
Reduction in required balance for Operating Reserve Account	147
PG&E remittance of past due amounts owed to DWR	539
Increased costs under terms of contracts	<u>(380)</u>
Net Reduction in 2003 Revenue Requirement	<u>\$ 1,002</u>

On September 4, 2003, the CPUC implemented the 2003 Supplemental Revenue Requirement which provides for credits for DWR Power Charges to IOU customers as follows (in millions).

Pacific Gas & Electric Company	\$ 444
Southern California Edison Company	423
San Diego Gas & Electric Company	<u>135</u>
	<u>\$1,002</u>

Department of Water Resources Electric Power Fund Management's Discussion and Analysis

Effective September 4, 2003, the Fund transferred \$147 million from the Operating Reserve Account to the Operating Account. The past due amounts from PG&E (net of the \$444 million bill credit for PG&E customers which is being held in trust by PG&E for DWR) was collected on September 11, 2003, and deposited in the Operating Account. The Operating Account then had sufficient funds on hand to be able to reduce its cash balances by \$558 million through bill credits for the customers of SCE and SDG&E and still remain in compliance with the minimum cash balance requirements of the Bond Indenture. For SCE and SDG&E customers, the bill credit is being implemented by reducing customer remittances from the IOUs to the Fund until such time (approximately two months) as the IOUs have, in effect, been reimbursed for the credits.

If the bill credit had been implemented on June 30, 2003, the Operating Account would have been reduced by \$316 million, the Operating Reserve Account would have been reduced by \$147 million, the current portion of recoverable costs would have been reduced by \$539 million, and long-term recoverable costs would have been increased by \$1,002 million.

FUTURE OPERATIONS

DWR will administer the Fund until such time as the revenue bonds are completely retired. Revenue requirements for the repayment of the bonds will be determined at least annually and submitted to the CPUC. Under the terms of the Rate Agreement between the CPUC and DWR, the CPUC is required to set rates for the customers of the IOUs and ESPs such that the Fund will always have monies to redeem the bonds when due.

DWR has the authority to administer all long-term power supply contracts entered into before December 31, 2002, for the life of the contracts. The last of the power supply contracts expires in 2013. Revenue requirements for the payment of energy purchased under the power supply contracts will be determined at least annually and submitted to the CPUC. Under the terms of the Rate Agreement between the CPUC and DWR, the CPUC is required to implement Power Charges such that the Fund will receive necessary monies to meet its revenue requirements.

DWR has been renegotiating a number of the power supply contracts in order to improve reliability and product quality, modify the conditions of assignment of the contracts to the IOUs, and reduce cost. Through June 30, 2003, DWR had renegotiated over 60%, in terms of both cost and volume of power, of the long-term contracts that had not otherwise expired. The estimated fixed and variable cost savings through 2013, when the final contract expires, is approximately \$6.3 billion.

Ultimately the financial responsibility for the long-term contracts may be transferred to the IOUs as part of a complete assignment of the contracts and release of DWR. However, there are a number of issues to be addressed, including IOU creditworthiness and counterparty approval, before the contracts can be assigned. For example, under the terms of the proposed CPUC/PG&E Settlement Agreement related to PG&E's bankruptcy, the DWR contracts will not be assigned to PG&E unless 1) PG&E's company credit rating after the assignment will not be less than "A" from Standard and Poors, and "A2" from Moody's; 2) the CPUC makes a finding that DWR contracts are just and reasonable, and 3) CPUC can ensure PG&E that it will receive full and timely recovery in its retail electric rates of all costs related to DWR contracts.

Department of Water Resources Electric Power Fund**Statements of Net Assets****June 30, 2003 and 2002****(in millions)**

	2003	2002
Assets		
Current assets:		
Cash and investments	\$ -	\$ 2,119
Restricted cash and investments:		
Operating Account	1,177	-
Priority Contract Account	84	-
Bond Charge Collection Account	156	-
Bond Charge Payment Account	229	-
Other investments	37	10
Recoverable costs, current portion	1,129	1,318
Interest receivable	15	32
Due from other funds	21	1
Total current assets	<u>2,848</u>	<u>3,480</u>
Long-term assets:		
Restricted cash and investments:		
Operating Reserve Account	777	-
Debt Service Reserve Account	927	-
Recoverable costs, net of current portion	7,568	7,263
Total long-term assets	<u>9,272</u>	<u>7,263</u>
Total assets	<u>\$ 12,120</u>	<u>\$ 10,743</u>
Capitalization and Liabilities		
Capitalization:		
Long-term debt:		
Revenue bonds	\$ 11,414	\$ -
Advances from State General Fund		
including accrued interest of \$402	-	6,496
Term loan	-	3,849
Total capitalization	<u>11,414</u>	<u>10,345</u>
Current liabilities:		
Current portion of long-term debt	222	-
Accounts payable	415	397
Accrued interest payable	69	1
Total current liabilities	<u>706</u>	<u>398</u>
Commitments and Contingencies (Notes 1 and 7)		
Total capitalization and liabilities	<u>\$ 12,120</u>	<u>\$ 10,743</u>

The accompanying notes are an integral part of these financial statements.

Department of Water Resources Electric Power Fund**Statements of Activities****For the years ended June 30, 2003 and 2002****(in millions)**

	2003	2002
Operating revenues:		
Power charges	\$ 4,517	\$ 4,139
Total operating revenues	<u>4,517</u>	<u>4,139</u>
Operating expenses:		
Power purchases	4,517	4,742
Administrative expenses	71	47
Deferral of recoverable operating costs	(71)	(650)
Total operating expenses	<u>4,517</u>	<u>4,139</u>
Income from operations	-	-
Bond charges	407	-
Interest income	61	102
Costs incurred for issuance of revenue bonds	(257)	(26)
Interest expense	(444)	(562)
Deferral of recoverable debt service and related costs	<u>233</u>	<u>486</u>
Net income	-	-
Net assets, beginning of year	-	-
Net assets, end of year	<u>\$ -</u>	<u>\$ -</u>

The accompanying notes are an integral part of these financial statements.

Department of Water Resources Electric Power Fund

Statements of Cash Flows

For the years ended June 30, 2003 and 2002

(in millions)

	2003	2002
Cash flows from operating income:		
Receipts from customers:		
Power charges	\$ 4,766	\$ 4,418
Payments for power purchases and other costs	(4,624)	(5,992)
Net cash provided by (used in) operating activities	<u>142</u>	<u>(1,574)</u>
Cash flows from non-capital financing activities:		
Proceeds from revenue bonds, net of underwriters' fees and bond insurance premiums	11,437	-
Receipts from customers for bond charges	352	-
Payments on term loan	(3,849)	(451)
Payments to State of California General Fund	(6,620)	(116)
Interest payments	<u>(282)</u>	<u>(237)</u>
Net cash provided by (used in) non-capital financing activities	<u>1,038</u>	<u>(804)</u>
Cash flows from investing activities:		
Investments purchased	(27)	(10)
Interest received on investments	78	80
Net cash provided by investing activities	<u>51</u>	<u>70</u>
Net increase (decrease) in cash and investments	1,231	(2,308)
Unrestricted cash and investments, beginning of year	<u>2,119</u>	<u>4,427</u>
Restricted (2003) and unrestricted (2002) cash and investments, end of year	<u>\$ 3,350</u>	<u>\$ 2,119</u>
Reconciliation of operating income to net cash provided by (used in) operating activities:		
Income from operations	<u>\$ -</u>	<u>\$ -</u>
Changes in net assets and liabilities to reconcile operating income to net cash used in operations:		
Recoverable costs	144	(403)
Due from other funds	(20)	6
Accounts payable	18	(1,177)
Total adjustments	<u>142</u>	<u>(1,574)</u>
Net cash provided by (used in) operating activities	<u>\$ 142</u>	<u>\$ (1,574)</u>

The accompanying notes are an integral part of these financial statements.

Department of Water Resources Electric Power Fund

Notes to Financial Statements

For the years ended June 30, 2003 and 2002

(in millions)

1. Reporting Entity

Background

In January 2001, the Governor of California issued an emergency proclamation directing the Department of Water Resources (DWR) to enter into contracts and arrangements for the purchase and sale of electric power to assist in mitigating the effect of a statewide energy supply emergency.

The Department of Water Resources Electric Power Fund (a component unit of the State of California) (Fund) was established on January 19, 2001, by Senate Bill 7 from the First Extraordinary Session of 2001 (SB7X). Assembly Bill 1 from the First Extraordinary Session of 2001 (AB1X), enacted on February 1, 2001, added Division 27 to the California Water Code to clarify and expand the powers of DWR to incur debt for the purposes of the Fund and to use amounts in the Fund for the purchase of power. The Fund is administered by DWR. Division 27 of the California Water Code (as subsequently amended by Senate Bill 31 from the First Extraordinary Session of 2001) includes the following powers and requirements:

- Authorizes DWR to act on behalf of the State of California to secure necessary power supplies for resale to customers of Pacific Gas & Electric Company (PG&E), Southern California Edison Company (SCE), and San Diego Gas & Electric Company (SDG&E) (collectively referred to as the investor owned utilities or IOUs).
- Requires DWR to retain title to all power sold, but authorizes DWR to enter into service agreements with the IOUs for transmission, distribution, billing and collection services.
- Authorize DWR and the California Public Utilities Commission (CPUC) to enter into an agreement with respect to charges to provide for recovery by DWR of its revenue requirements.
- Authorizes DWR to issue bonds in an amount not to exceed \$13.4 billion and payable solely from the Fund, and to deposit the proceeds of the bonds in the Fund for use for any of the purposes of the Fund.
- Entitles DWR to recover its revenue requirements incurred in connection with its authorized activities, including debt service, the costs of power purchases, administrative costs and reserves.
- Prohibits DWR from entering into new power purchase agreements after December 31, 2002, but allows DWR to continue to administer existing contracts and enforce revenue requirements beyond that date.

DWR began selling electricity to approximately ten million retail customers in California in January 2001. DWR purchases power from wholesale suppliers under long-term contracts and, through December 31, 2002, in short-term and spot market transactions. DWR power is delivered to the customers through the transmission and distribution systems of the IOUs and payments from the customers are collected for DWR by the IOUs pursuant to servicing arrangements approved and/or ordered by the CPUC. DWR initially financed its power purchases with advances from the General Fund of the State of California, loans from financial institutions, and revenues from power sales to customers. The advances from the General Fund and the remaining balance of the loans from financial institutions were repaid from the proceeds of revenue bonds issued in October and November 2002.

Department of Water Resources Electric Power Fund

Notes to Financial Statements

For the years ended June 30, 2003 and 2002

(in millions)

Litigation and Uncertainties

DWR is involved in several lawsuits and regulatory proceedings. In one action (“PG&E1”), PG&E contested the determination of DWR’s revenue requirement submissions for calendar years 2001 and 2002. The trial court found that DWR had failed to follow the California Administrative Procedures Act (APA) and ordered DWR to do so. The trial court also ruled that its decision did not affect any prior actions taken by the CPUC, including the implementation of cost recovery of DWR’s calendar years 2001 and 2002 revenue requirements. This ruling was appealed and was affirmed in part and reversed in part, on October 2, 2003, with the appellate court concluding that “AB1X does require DWR to make a determination that its revenue requirement is just and reasonable, but neither AB1X nor the APA requires a public hearing or compliance with the APA procedures.” The decision of the Court of Appeals in PG&E1 will not be final until the time for appeal passes without appeal by either party.

In August 2002, during the pendency of the appeal of PG&E1, DWR determined its 2003 revenue requirement and re-examined its 2001-2002 revenue requirements and filed them with the CPUC. In October 2002, PG&E filed a lawsuit (“PG&E2”) on the 2003 revenue requirements and the re-examined 2001-2002 revenue requirements, claiming that DWR had not adequately followed APA requirements or DWR’s own regulations and claiming that a portion of DWR’s revenue requirements were unjust and unreasonable and therefore invalid. DWR has filed a motion to stay PG&E2.

In another matter, two energy suppliers have petitioned the Federal Energy Regulatory Commission (“FERC”), contending that amounts totaling \$58 million are owed by DWR for power purchased in the last half of January 2001, by DWR on behalf of PG&E and SCE in the California Independent System Operator (ISO) market. DWR maintains that the Fund has remitted the appropriate payments to the ISO for distribution to the energy suppliers. The ISO distributed the Fund’s January payment on a pro-rata basis to all market participants for the entire month, although DWR purchased power on behalf of the two IOUs beginning in late January. As a result, energy suppliers did not receive full payment for the amounts owed them for power purchased in January by DWR on behalf of the two IOUs. On November 25, 2002, FERC issued an order finding that the ISO had “misapplied the payment it received from CERS” and directed the ISO to “reallocate its pro-rata disbursement for the entire month of January 2001, and disburse funds from DWR allocated for January 2001, to those that supplied power for the period January 17 – 31, 2001.” The ISO recently submitted a filing to FERC outlining its process of calculating the distribution of funds from DWR. Resolution of this matter is still pending at FERC.

Additionally, various actions are underway contesting certain long-term power contracts entered into by DWR.

There are a number of other lawsuits and regulatory proceedings in which DWR is not a party but may be affected by the result because of potential impacts on the price or supply of energy in California. In one case, California Power Exchange Corporation (CalPX), certain IOUs and others have brought suit against the State of California claiming that the State’s commandeering of CalPX’s block forward contracts after CalPX filed bankruptcy in early 2001 was unconstitutional. The plaintiffs argue that they are entitled to damages of \$1.1 billion, which is their estimation of the fair value of the block forward contracts at the time of commandeering. Under the block forward contracts, which expired in December 2001, the Fund paid approximately \$350 million for energy provided by the contracts.

Department of Water Resources Electric Power Fund

Notes to Financial Statements

For the years ended June 30, 2003 and 2002

(in millions)

These lawsuits and regulatory proceedings could impact power costs and the related revenue requirements, and the terms and conditions of the power purchase contracts (Note 7).

Management believes that the existing lawsuits and regulatory proceedings will be resolved in calendar year 2004. Because of the early stage of the legal and regulatory proceedings, the ultimate outcome of these matters cannot be presently determined.

2. Summary of Significant Accounting Policies

Basis of Presentation

The Fund is accounted for as an enterprise fund and is financed and operated in a manner similar to that of a private business enterprise. The Fund uses the economic resources measurement focus and the accrual basis of accounting. Under this method, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred. As allowed by governmental accounting standards, the Fund has elected not to apply statements and related interpretations issued by the Financial Accounting Standards Board after November 30, 1989. The Fund is accounted for with a set of self-balancing accounts that comprise its assets, liabilities, fund equity, revenues and expenses.

Restricted Cash and Investments

Restricted cash and investments, for purposes of the statements of cash flows, includes cash on hand and amounts in short-term investments. Amounts in short-term investments include deposits in the State of California Pooled Money Investment Account-Surplus Money Investment Fund (SMIF).

Cash not required for current use is invested in SMIF. SMIF has an equity interest in the State of California Pooled Money Investment Account (PMIA). Generally, the investments in PMIA are available for withdrawal on demand.

PMIA funds are on deposit with the State's Centralized Treasury System and are managed in compliance with the California Government Code, according to a statement of investment policy which sets forth permitted investment vehicles, liquidity parameters and maximum maturity of investments. These investments consist of U.S. government securities, securities of federally-sponsored agencies, U.S. corporate bonds, interest bearing time deposits in California banks, prime-rated commercial paper, bankers' acceptances, negotiable certificates of deposit, repurchase and reverse repurchase agreements. The PMIA policy limits the use of reverse repurchase agreements subject to limits of no more than 10% of PMIA. The PMIA does not invest in leveraged products or inverse floating rate securities. The PMIA cash and investments are recorded at amortized cost, which approximates market.

The investment in PMIA, an investment pool managed by the State of California, does not meet the criteria to require risk categorization.

Department of Water Resources Electric Power Fund

Notes to Financial Statements

For the years ended June 30, 2003 and 2002

(in millions)

Under the terms of the Bond Indenture separate restricted cash and investment accounts were established. The accounts and their purpose follow:

Bond Charge Accounts:

- Bond Charge Collection Account: Bond Charges are specific charges to IOU customers and certain customers of “direct access” Electric Service Providers (ESPs) based on all power (including DWR, IOU and ESP power) delivered to such customers and are used for debt service and other debt related costs. Bond Charges are deposited into the Bond Charge Collection Account. Monthly, funds needed for debt service payments are transferred to the Bond Charge Payment Account.
- Bond Charge Payment Account: Monies in the Bond Charge Payment Account are used to pay debt service, swap payments and related fees for the revenue bonds. After receipt of the monthly transfer from the Bond Charge Collection Account, the balance in the Bond Charge Payment Account must at least equal debt service, swap payments and fees estimated to accrue or be payable for the next succeeding three months.
- Debt Service Reserve Account: The Debt Service Reserve account is to be funded at all times with the amount of maximum aggregate annual debt service on all outstanding debt, including net scheduled swap payments.

Power Charge Accounts:

- Operating Account: Power Charges are charges to IOU and certain ESP customers for all DWR power purchased by the Fund for the benefit of the IOU customers. Power Charges and miscellaneous revenue are deposited into the Operating Account. Monthly, funds are transferred to the Priority Contract Account as needed to make payments on Priority Contracts. Remaining monies are available for payment of all operating costs of the Fund other than Priority Contracts, debt service, and debt-related costs.
- Priority Contract Account: Priority Contracts are those long-term power purchase contracts that require monthly payment prior to any debt service payments. Monies in the Priority Contract Account are used to make scheduled payments on Priority Contracts. After the monthly transfer from the Operating Account on the fifth of the month, the Priority Contract Account is projected to have monies sufficient to make scheduled payments on Priority Contracts through the fifth of the following month.
- Operating Reserve Account: The Operating Reserve account must maintain a balance equal to the greater of (i) seven months of projected negative operating cash flows under a stress scenario, as defined, or (ii) twelve percent of projected annual operating expenses of the Fund, as defined.

Other Investments

The Fund maintains a brokerage account with a national brokerage firm in order to take positions in futures and options so as to hedge natural gas fuel costs. Natural gas future and option agreements are reported at fair value on the balance sheet. The Department does not enter into natural gas future

Department of Water Resources Electric Power Fund

Notes to Financial Statements

For the years ended June 30, 2003 and 2002

(in millions)

and option agreements for trading purposes, but rather to take advantage of favorable pricing. The Fund is exposed to risk of nonperformance if the counter parties default or if the future or option agreements are terminated. The Fund's position underlying open natural gas future and option agreements totaled \$16 million and \$1 million at June 30, 2003 and 2002, respectively. It is possible that the market price before or at the specified time to purchase natural gas may be lower than the price at which the Fund is committed to buy. This would reduce the value of the contract. The Fund could sell the contract at a loss, or if it were to continue to hold the contract, the Fund may make a termination payment to the counterparty to cancel its obligation under the contract and then buy natural gas on the open market.

The brokerage firm requires that the Fund maintain a security deposit, which is invested in compliance with the California Government Code. These funds are invested in money market mutual funds and government bonds and are carried at fair value. The investment in money market mutual funds amounted to \$20 million at June 30, 2003 and \$7 million at June 30, 2002, respectively, and is not subject to risk categorization. The investments in government bonds amounting to \$1 million and \$2 million at June 30, 2003 and 2002, respectively, and the natural gas future and option agreements noted above are considered Category 1 investments that are insured or registered or for which the securities are held by the Fund or its agent in the Fund's name.

Revenues and Recoverable Costs

Before the issuance of revenue bonds, the cost of energy provided by DWR and debt service was recovered through charges to the customers of the IOUs as authorized by AB1X and established by the CPUC. Revenues were recognized when energy provided by DWR was delivered to the customers. Prior to the issuance of the revenue bonds, costs were recovered through Power Charges. Since the issuance of the revenue bonds, customer charges are separated into two primary components, Power Charges and Bond Charges. Power Charge revenues recover the cost of power purchases, administrative costs and operating reserves and are recognized when energy provided by DWR is delivered to the customers. Certain customers of ESPs are assessed "cost responsibility surcharges" that are used by DWR for the same purposes as Power Charge revenues. Bond Charge revenues recover debt service and debt service reserves and are recognized when energy provided by either DWR or the IOU, or an ESP, is delivered to customers. Costs are recovered over a period of time as determined by DWR's revenue requirement process.

For the year ended June 30, 2003 and 2002, the Power Charges were reduced by \$113 million and \$221 million, respectively, for rebates given to the customers of the IOUs under the Governor's "20-20 Energy Rebate Program," which, during the summer peak demand months, generally granted the customers a 20% reduction in their monthly power bills if they reduced their energy use by 20% from the same period in the previous year. These reductions extend the period of time over which the Fund will recover its costs.

Amounts that have been earned but not collected are recorded as the current portion of recoverable costs. Costs that are recoverable through future billings are recorded as long-term.

Change in Accounting Principle

In June 2003, the Governmental Accounting Standards Board (GASB) issued GASB Technical Bulletin 2003-1, *Disclosure Requirements for Derivatives Not Reported at Fair Value on the Statement of Net Assets*. DWR has adopted the provisions of GASB Technical Bulletin 2003-1 as

Department of Water Resources Electric Power Fund

Notes to Financial Statements

For the years ended June 30, 2003 and 2002

(in millions)

required for the year ended June 30, 2003. The adoption of GASB Technical Bulletin 2003-1 requires disclosure of certain information related to derivatives that are not reported at fair value on the statement of net assets, including the objective of the derivative, significant terms, fair value, associated debt and certain risks (credit, interest rate, basis, termination, rollover, and market-access risks). During the year ended June 30, 2003, DWR, on behalf of the Fund, entered into interest rate swap agreements with various counterparties, to reduce variable interest rate risk. Disclosures required by GASB Technical Bulletin are included in Note 5.

3. Cash and Investments

Interest on deposits in PMIA varies with the rate of return of the underlying portfolio and approximated 2.16% and 3.42% at June 30, 2003 and 2002, respectively. For the years ended June 30, 2003 and 2002, interest earned on the deposit in PMIA was \$61 million and \$99 million, respectively.

Additionally, on June 30, 2003, an amount of \$6.8 million was in custody of a national bank that serves as the co-trustee for the purpose of servicing the swap transactions on the variable portion of the bond debt and is included in the Bond Charge Payment Account. Of the bank balance, \$.1 million is federally insured and \$6.7 million is uninsured and uncollateralized.

Department of Water Resources Electric Power Fund

Notes to Financial Statements

For the years ended June 30, 2003 and 2002

(in millions)

4. Long-Term Debt

The following activity occurred in the long-term debt accounts during the two years ended June 30, 2003 (dollars in millions):

	General Fund Advances	Term Loan	Revenue Bonds	Unamor- tized Premium	Total Revenue Bonds	Total Long-term Debt
Balance, June 30, 2001	\$ 6,169	\$ 3,909	\$ -	\$ -	\$ -	\$ 10,078
Accrued Interest	327	-	-	-	-	327
Payments	-	(60)	-	-	-	(60)
Balance, June 30, 2002	6,496	3,849	-	-	-	10,345
Accrued Interest	124	-	-	-	-	124
Payments	-	(385)	-	-	-	(385)
Sale of revenue bonds	(6,620)	(3,464)	11,264	397	11,661	1,577
Amortization of premium	-	-	-	(25)	(25)	(25)
Balance, June 30, 2003	-	-	11,264	372	11,636	11,636
Less current portion	-	-	180	42	222	222
	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 11,084</u>	<u>\$ 330</u>	<u>\$ 11,414</u>	<u>\$ 11,414</u>

On October 30, 2002, DWR issued \$4.3 billion of tax-exempt variable rate revenue bonds. On November 14, 2002, DWR issued \$6.3 billion in tax-exempt fixed rate revenue bonds and \$.7 billion in taxable fixed rate revenue bonds. The proceeds of the bonds, along with the cash balance in the Fund at the date of issuance, were used to repay previously incurred debt and fund restricted cash and investment accounts as required by the Bond Indenture.

The average interest rate for the term loan was 5.7% for the year ended June 30, 2002, and 5.1% for the period from July 1, 2002, until the loan was repaid on October 30, 2002. Interest expense on the term loan was \$60 million and \$235 million for the years ended June 30, 2003 and 2002, respectively. The average interest rate on the advances from the General Fund approximated 5.31% from July 1, 2001, until the advances were repaid on November 14, 2002. Interest expense on the advances from the General Fund was \$124 million and \$327 million for the years ended June 30, 2003 and 2002, respectively.

Department of Water Resources Electric Power Fund

Notes to Financial Statements

For the years ended June 30, 2003 and 2002

(in millions)

The revenue bonds consist of the following at June 30, 2003:

Series	Rates	Fiscal Year of Final maturity	Fiscal Year of First Call Date	Amounts Outstanding (in millions)
A	3.0-6.0%	2022	2012	\$ 6,314
B	Variable	2020	Callable	1,000
C	Variable	2022	Callable	2,750
D	Variable	2022	Callable	500
E	3.6-4.3%	2006	Not callable	700
				<hr/> 11,264
Plus unamortized bond premium				372
Less current maturities				<hr/> (222)
				<hr/> \$ 11,414

The variable rate bonds had a set interest rate of 1.8% through early January 2003, at which time Series B and C converted to daily and weekly rate modes, respectively, and Series D converted to 35-day auction periods. The variable rate bonds have a final stated maturity of 2022, but will be retired in sinking fund installments from 2005 to 2022. Total interest cost through June 30, 2003, for all revenue bonds was \$158 million. The interest rates for the variable debt from early January 2003 through June 30, 2003, ranged from 0.70% to 1.80%.

Principal and interest payments are secured by bond charges. The Fund is subject to certain bond covenants, including establishing funding and expenditure requirements for several restricted cash and investment accounts. The bonds are limited special obligations of the Fund; neither the principal nor any interest thereon constitutes a debt of the State. The payment of principal and interest for Series B (relating to \$1 billion in principal) and certain Series C bonds (\$1.75 billion out of a total Series C size of \$2.75 billion) are paid from draws made under letters of credit. In the case of these bonds, draws made under the letters of credit are to be reimbursed on the same day by the Fund.

There are no outstanding amounts on the letters of credit at June 30, 2003. The letters of credit expire in during 2005. The Fund pays fees of 0.85% per annum on the stated amount of the letters of credit.

The remaining \$1 billion of Series C bonds is credit enhanced by bond insurance. Liquidity support for these bonds is provided by bank liquidity facilities. Any funds paid under the bond insurance or liquidity facilities are immediately due and payable by the Fund. There are no outstanding amounts on liquidity facilities at June 30, 2003. Three liquidity facilities backing \$300 million in Series C bonds expire in 2005, and two liquidity facilities underlying \$700 million of Series C bonds expire in 2009. The Fund pays fees of between 0.22% and 0.37% per annum on the liquidity facilities.

Department of Water Resources Electric Power Fund

Notes to Financial Statements

For the years ended June 30, 2003 and 2002

(in millions)

Future payment requirements on the revenue bonds are as follows at June 30, 2003 (in millions):

Fiscal Year	Principal	Interest ¹	Total
2004	180	404	584
2005	388	398	786
2006	409	381	790
2007	427	364	791
2008	449	345	794
2009-2013	2,612	1,410	4,022
2014-2018	3,397	788	4,185
2019-2022	3,402	186	3,588
	<u>\$ 11,264</u>	<u>\$ 4,276</u>	<u>\$ 15,540</u>

¹ Variable portion of interest cost calculated using the June 30, 2003 Bond Market Association Municipal Swap Index (BMA).

5. Interest Rate Swaps

DWR, on behalf of the Fund, entered into interest rate swap agreements with various counterparties, to reduce variable interest rate risk. The swaps create a synthetic fixed rate for DWR. DWR has agreed to make fixed rate payments and receive floating rate payments on notional amounts equal to a portion of the principal amount of DWR's variable rate debt.

The terms, fair values, and credit ratings of counterparties for the various swap agreements, all of which became effective February 1, 2003, are summarized in the following table:

Department of Water Resources Electric Power Fund

Notes to Financial Statements

For the years ended June 30, 2003 and 2002

(in millions)

Outstanding Notional Amount at June 30, 2003	Fixed Rate Paid by Fund	Variable Rate Received by the Fund ¹	Fair Values at June 30, 2003	Swap Termination Date	Counterparty Credit Ratings (Moody's, Fitch's, S&P)
\$ 94	2.914%	80% of LIBOR ²	\$ (4)	5/1/2011	Aaa, AAA, AAA
234	3.024%	80% of LIBOR	(11)	5/1/2012	Aaa, AAA, AAA
200	3.405%	BMA	(9)	5/1/2013	Aa3, AA-, AA-
100	3.405%	BMA	(4)	5/1/2013	Aa3, AA-, A+
30	3.405%	BMA	(1)	5/1/2013	Aa3, AA-, A+
194	3.204%	80% of LIBOR	(10)	5/1/2014	Aa1, AA, AA-
174	3.280%	80% of LIBOR	(10)	5/1/2015	Aaa, AAA, AAA
202	3.342%	80% of LIBOR	(11)	5/1/2016	Aa3, AA-, A+
202	3.389%	80% of LIBOR	(12)	5/1/2017	Aa3, AA-, A+
\$ 1,430			\$ (72)		

¹ LIBOR based swaps convert to pay the Fund 67% of LIBOR on January 1, 2004

² One month U.S. Dollar London Interbank Offered Rate

The notional amounts of the swaps match the principal amounts of the associated debt. The swap agreements contain scheduled reductions to outstanding notional amounts that follow scheduled amortization of the associated debt.

Fair Value: Because interest rates have declined, all swaps had a negative fair value as of June 30, 2003. The reported fair values from the table above were provided by the counterparties, using the par value, or marked-to-market, method.

Credit Risk: As of June 30, 2003, the Fund was not exposed to credit risk because the swaps had negative fair values. However, should interest rates increase and the fair values become positive, the Fund would be exposed to credit risk in the amount of the swaps' fair value. DWR has a total of nine swap agreements with six different counterparties. Three swaps, approximating 35 percent of the total notional value are with one counterparty with a credit rating of Aaa/AAA/AAA. Of the remaining swaps, two are held with a single counterparty, approximating 21 percent of the outstanding notional value. That counterparty has credit ratings of Aa3/AA-/A+. The remaining four swaps are with separate counterparties, all having Aa3/AA-/A+ ratings or better.

Basis Risk: The Fund is exposed to basis risk on the swaps that have payments calculated on the basis of a percentage of LIBOR (a taxable rate index). The basis risk results from the fact that DWR's floating interest payments payable on the underlying debt are determined in the tax-exempt market, while DWR's floating receipts on the swaps are based on LIBOR, which is determined in the taxable market. Should the relationship between LIBOR and the tax-exempt market change and move to convergence, or should DWR's bonds trade at levels worse (higher in rate) in relation to the tax-exempt market, DWR's all-in costs would increase. As of June 30, 2003, the variable rate on

Department of Water Resources Electric Power Fund

Notes to Financial Statements

For the years ended June 30, 2003 and 2002

(in millions)

DWR's bonds ranged from .70% to 1.80%, while 80% of LIBOR received on the swap was equal to 0.89%.

Termination Risk: DWR's swap agreements do not contain any out-of-the-ordinary termination events that would expose it to significant termination risk. In keeping with market standards, DWR or the counterparty may terminate a swap agreement if the other party fails to perform under the terms of the contract. In addition, the swap documents allow either party to terminate in the event of a significant loss of creditworthiness by the other party. DWR views such events to be remote at this time. If a termination were to occur, at the time of the termination, DWR would be liable for payment equal to the swap's fair value, if it had a negative fair value at that time. The counterparty would be liable for any payment equal to the swap's fair value, if it had positive fair value at that time. In addition, a termination would mean that DWR's underlying floating rate bonds would no longer be hedged, and DWR would be exposed to floating rate risk, unless it entered into a new hedge following termination.

Rollover Risk: Since the swap agreements have termination dates and notional amounts that are tied to equivalent maturity dates and principal amounts of amortizing debt, there is no rollover risk associated with the swap agreements, other than in the event of a termination.

Swap Payments and Associated Debt: As rates vary, variable-rate bond interest payments and net swap interest payments will vary. As of June 30, 2003, debt service requirements of the variable-rate debt and net swap payments, assuming current interest rates remain the same, for their term were as follows (in millions):

Fiscal Year Ending June 30	Variable Rate Bonds		Interest Rate Swaps, Net	Total
	Principal	Interest		
2004	\$ -	\$ 15	\$ 31	\$ 46
2005	-	15	31	46
2006	-	15	31	46
2007	-	15	31	46
2008	-	15	31	46
2009-2013	658	71	148	877
2014-2017	772	21	44	837
Total	\$ 1,430	\$ 167	\$ 347	\$ 1,944

Department of Water Resources Electric Power Fund

Notes to Financial Statements

For the years ended June 30, 2003 and 2002

(in millions)

6. Retirement Plan

Plan Description

The State of California is a member of the California Public Employees' Retirement System (PERS), an agent multiple-employer pension system that provides a contributory defined-benefit pension for substantially all State employees. DWR is included in the State Miscellaneous Category (Tier 1 and Tier 2) within PERS, thereby limiting the availability of certain DWR pension data. PERS functions as an investment and administrative agent for participating public agencies within the State of California. Departments and agencies within the State of California, including DWR, are in a cost-sharing arrangement in which all risks and costs are shared proportionately by participating State agencies. Copies of PERS' comprehensive annual financial report may be obtained from their executive office at 400 P Street, Sacramento, California 95814.

The pension plan provides retirement benefits, survivor benefits, and death and disability benefits based upon employee's years of credited service, age and final compensation. Vesting occurs after five years of credited service except for second tier benefits, which require ten years of credited service. Employees who retire at or after age 50 with five or more years of service are entitled to a retirement benefit, payable monthly for the remainder of their lives. Several survivor benefit options which reduce a retiree's unmodified benefit are available. Benefit provisions and all other requirements are established by state statute.

Annual Pension Cost

For the years ended June 30, 2003 and 2002, DWR's annual pension cost and actual contribution allocated to the Fund based on the Fund's payroll costs amounted to less than \$1 million.

7. Commitments and Contingencies

Commitments

DWR has entered into power purchase contracts that have remaining lives of up to eleven years. Payments made under these contracts approximated \$3.7 billion and \$2.5 billion for the years ended June 30, 2003 and 2002, respectively.

The remaining amounts of fixed obligations under the contracts as of June 30, 2003, are as follows:

For the Year Ending June 30,	Fixed Obligation (in millions)
2004	\$ 3,632
2005	3,190
2006	2,809
2007	2,525
2008	2,378
Thereafter	5,681
	<u>\$ 20,215</u>

Department of Water Resources Electric Power Fund

Notes to Financial Statements

For the years ended June 30, 2003 and 2002

(in millions)

In addition to the fixed costs there are variable costs with several of the contracts. Management expects that the amount of fixed and variable obligations associated with long-term power purchase contracts to approximate \$30 billion as of June 30, 2003. The difference between the fixed costs and the expected total costs of the contracts are primarily due to the variable factors associated with dispatchable contracts and the cost of natural gas.

DWR has been renegotiating a number of the power supply contracts in order to improve reliability and product quality, modify the conditions of assignment of the contracts to the IOUs, and reduce cost. Through June 30, 2003, DWR has renegotiated over 60%, in terms of both cost and volume of power, of the long-term contracts that have not otherwise expired.

Contingencies

The Fund is self-insured for most risks, including general liability and workers' compensation. Management believes that any costs associated with such losses are recoverable from customers as part of DWR's revenue requirement.

8. Related Party Transactions

During the years ended June 30, 2003 and 2002, the Fund purchased power approximating \$6 million and \$11 million, respectively, from the State Water Resources Development System (System), another enterprise fund administered by DWR. Additionally, the Fund sold power to the State Water Resources Development System amounting to \$5 million during each of the years ended June 30, 2003 and 2002, respectively. Net amounts owed to the Fund by the System for power purchases and sales were \$3 million and \$1 million at June 30, 2003 and 2002, respectively. Additionally, during the year ended June 30, 2003, the Fund advanced \$20 million to DWR's internal service fund, which functions as a revolving working capital facility for the Fund.

9. Subsequent Event

Based on 1) the ability to reduce reserves as allowed under the Bond Indenture, 2) the expected receipt of cash for past due amounts being held in trust by PG&E, and 3) increases in actual and forecasted costs, in July 2003, DWR decreased its 2003 revenue requirement by \$1.002 billion. On September 4, 2003, the PUC ordered implementation of the decrease in revenue requirements through credits for DWR Power Charges in the monthly billings to IOU customers from mid September through mid October 2003.

If the bill credit had been completely implemented on June 30, 2003, the Operating Account would have been reduced by \$316 million, the Operating Reserve Account would have been reduced by \$147 million, the current portion of recoverable costs would have been reduced by \$539 million, and long-term recoverable costs would have been increased by \$1,002 million.